No. 97-

In the
Supreme Court of the United States
October Term, 1997

ATLANTIC MUTUAL INSURANCE CO. and
Includible Subsidiaries,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Third Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the United States Court of Appeals for the Third Circuit incorrectly reversed a decision of the United States Tax Court, which, consistent with a decision of the United States Court of Appeals for the Eighth Circuit, held that Treas. Reg. § 1.846-3(c)(3) is not a valid interpretation of the term "reserve strengthening" used in § 1023(e)(3) of the Tax Reform Act of 1986?

PARTIES TO THE PROCEEDING

All the parties are named in the caption.

STATEMENT PURSUANT TO RULE 29.6

There are no parent or subsidiary companies to be listed under the provisions of Rule 29.6.

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PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF
APPEALS FOR THE THIRD CIRCUIT.

PETITION FOR WRIT OF CERTIORARI

Atlantic Mutual Insurance Company and Includible Subsidiaries respectfully petition for a writ of certiorari to review the judgement and opinion issued by the court below.

OPINIONS BELOW

The opinion of the Third Circuit is reported at 111 F.3d 1056 and is set forth in its entirety in the Appendix hereto at A-1. The opinion of the Tax Court, reversed by the Third Circuit, is reported as *Atlantic Mutual Insurance Co. v. Commissioner*, 71 T.C.M. (CCH) 2154 (1996) and is set forth in the Appendix at A-26.

JURISDICTION

The decision below was issued by the Third Circuit on April 24, 1997 and judgment was entered on that date. Petitioner herein, Atlantic Mutual Insurance Company and Includible Subsidiaries (hereinafter "Atlantic"), did not file a petition for rehearing in the Third Circuit. In accordance with 28 U.S.C. § 2101(c), this Petition is filed within ninety days of the date judgment was entered. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The relevant portions of the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1023, 100 Stat. 2085, 2404; of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 216, 98 Stat. 494, 758; and of Treas. Reg. § 1.846-3(c) (26 C.F.R. § 1.846-3(c)) (hereinafter sometimes referred to as the "regulation") are set forth in the Appendix at A-48, A-50, and A-52, respectively.

STATEMENT OF THE CASE

Atlantic is a property and casualty ("P&C") insurer. Since 1921, P&C insurers have been allowed, for federal income tax purposes, to reduce income by the amount of their "losses incurred" each year, including any increases in reserves for unpaid losses and loss adjustment expenses arising under insurance and reinsurance policies ("loss reserves"). In § 1023 of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2404 (the "Act"), Congress required that P&C insurers discount to present value loss reserves taken into account in computing losses incurred each year. Under the provisions of the Act, loss reserves were to be discounted beginning in 1987.

Congress recognized that the use of discounted loss reserves at year-end 1987 and undiscounted loss reserves at year-end 1986 to compute the deduction for losses incurred in 1987 would severely impact P&C insurers by requiring them to include in income in 1987 the entire amount of the difference between undiscounted and discounted loss reserves. Congress, therefore, provided a "fresh start" in § 1023(e)(3)(A) of the Act. Thus, year-end 1986 loss reserves were not required to be discounted in the computation of the deduction for losses incurred in 1986, while for purposes of computing the deduction for losses incurred in 1987, both the year-end 1986 and 1987 loss reserves were to be discounted. The difference between the undiscounted and discounted amounts of the year-end 1986 loss reserves, i.e., the "fresh start," was permanently excluded from taxable income. Recognizing, however, that the fresh start provision could be subject to abuse, Congress provided in § 1023(e)(3)(B) of the Act that the amount of the discount on any increase in loss reserves due to "reserve

strengthening" in 1986 would be eliminated from the fresh start. Any such elimination results in an increase in 1987 taxable income.

On September 4, 1992, the Treasury Department issued a sweeping regulatory interpretation of the phrase "reserve strengthening" in § 1023(e)(3)(B) of the Act. For loss reserves at year-end 1986 for losses that occurred in 1985 and prior years ("pre-1986 accident years"), the regulation includes a so-called "mechanical test" for reserve strengthening. If a reserve at December 31, 1986 for pre-1986 accident year losses exceeded the amount of the reserve at December 31, 1985 less the amount paid in 1986 on those losses, the excess is automatically deemed "reserve strengthening." Treas. Reg. §§ 1.846-3(c)(1) and (3). In short, the regulation sweeps into the definition of "reserve strengthening" all 1986 increases in loss reserves for pre-1986 accident years. The regulation applies the definition without regard to whether such increases resulted from changes in a P&C insurer's reserving methods or assumptions or from normal and routine increases in a P&C insurer's policy liabilities.[1]

The relevant facts in this case involving the validity of Treas. Reg. §§ 1.846(c)(3) are not in dispute. Atlantic is the common parent of affiliated corporations filing a consolidated return. The parties stipulated: 1) Atlantic's loss reserves were reasonable in amount at the end of 1985 and 1986; 2) in establishing its loss reserves as of December 31,

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[1]In fact, the mechanical test also includes in "reserve strengthening" the excess of any 1986 loss payment over the related year-end 1985 loss reserve even though that loss reserve was eliminated as of year-end 1986 by reason of the payment and, therefore, there could not be any addition made to a reserve.

1986, Atlantic computed its loss reserves using the same methodologies and assumptions used in determining its loss reserves as of December 31, 1985; 3) measured by subsequent payments and loss reserves remaining to be paid as of December 31, 1993, Atlantic's 1986 loss reserves were more inadequate than its 1985 loss reserves; and 4) Atlantic did not increase in 1986 its loss reserves for pre-1986 accident years for tax motivated reasons.

In its tax return for 1987, Atlantic included the entire difference between its undiscounted and discounted loss reserves at December 31, 1986 in the fresh start allowed by the Act. Based on the mechanical test of § 1.846-3(c)(3) of the regulation, Respondent determined that a portion of Atlantic's year-end 1986 loss reserves for pre-1986 accident years resulted from reserve strengthening. Respondent calculated the amount of reserve strengthening by subtracting from Atlantic's year-end 1986 loss reserves for pre-1986 accident years the net of its loss reserves at year-end 1985 less payments made in respect of such loss reserves during 1986. Based on this determination, Respondent issued a statutory notice of deficiency to Atlantic.

Atlantic petitioned the United States Tax Court for redetermination of the deficiency pursuant to §§ 6213(a) and 7442 of the Internal Revenue Code. The matter was submitted to the court for decision on the basis of facts which were fully stipulated except for the testimony contained in the reports of four expert witnesses regarding the meaning of the term "reserve strengthening" in P&C insurance. The Tax Court relied on its prior decision (reviewed by the entire court) in *Western National Mutual Insurance Co. v. Commissioner*, 102 T.C. 338 (1994), *aff'd*, 65 F.3d 90 (8th Cir. 1995), which held that the term "reserve

strengthening" is not ambiguous and that the regulation at issue is invalid to the extent that it defines all additions to reserves as reserve strengthening. As a consequence, the Tax Court determined that Atlantic was not liable for the proposed deficiency because Atlantic had made no reserve increases constituting "reserve strengthening" within the meaning of the Act.

Respondent appealed the Tax Court's decision to the Court of Appeals for the Third Circuit. In a decision entered April 24, 1997, the Third Circuit reversed the decision of the Tax Court, and in so doing, it expressly refused to follow the decision of the Eighth Circuit in *Western National*. Directly contrary to the decision of the Eighth Circuit, the Third Circuit found the term "reserve strengthening" in the statute to be ambiguous and the regulation to be a permissible construction of the statute.

REASONS FOR GRANTING THE PETITION

The decision of the Third Circuit directly conflicts with the Eighth Circuit's decision in *Western National Mutual Insurance Co. v. Commissioner*, 65 F.3d 90 (8th Cir. 1995), *aff'g*, 102 T.C. 338 (1994), a case involving facts which the Tax Court here found to be indistinguishable. Because the issue involved affects a broad segment of the insurance industry, a decision of this Court is necessary to assure uniformity of treatment consistent with the proper application of federal tax laws. Further, the reasoning of the Third Circuit conflicts with standards of statutory interpretation established by this Court which should have resulted in a determination that the regulation is invalid to the extent it defines all additions to reserves as reserve strengthening.

I.

The Decision Below Is in Direct Conflict with a Decision of the Court of Appeals for the Eighth Circuit and That Conflict Will Have Serious Repercussions for P&C Insurers.

The decision of the Third Circuit directly conflicts with the decision of the Eighth Circuit. In reversing the Tax Court's holding, the Third Circuit referred to the holding of the Court of Appeals for the Eighth Circuit that § 1.846-3(c) is invalid in relevant part. The court then stated that "[w]e respectfully disagree." *Atlantic Mutual Insurance Co. v. Commissioner*, 111 F.3d 1056, 1061, n. 7 (3d Cir. 1997).

The conflicting decision of the Eighth Circuit in *Western National* is recent and thoroughly reasoned. It affirms a decision of the Tax Court that was reviewed by the entire court. The Third Circuit did not rely upon any statutory or judicial developments subsequent to the issuance of the Tax Court and Eighth Circuit decisions which could change the decisions reached by those courts in *Western National*. A conflict is thus certain to persist even after other federal courts have an opportunity to consider the issue.

As a result, uniformity of treatment of different taxpayers with respect to this industry issue cannot be attained without resolution by this Court. Respondent stated in her brief to the Third Circuit in this case that the identical issue is pending in approximately 50 other cases with total adjustments of $1,000,000,000. There will be disparate treatment for litigants in different jurisdictions unless and until this Court ultimately rules on the issue.

In short, this case presents an ideal opportunity for resolution of a conflict that will continue and cannot be resolved short of a decision by this Court. The Tax Court specifically held that this case is "factually indistinguishable" from *Western National*. Although there was some differing expert testimony in each case regarding the definition of the term "reserve strengthening" in the insurance industry, the Eighth Circuit indicated that it would have reached the same conclusion without regard to expert testimony. The Tax Court and Eighth Circuit, on the one hand, and the Third Circuit, on the other, have fleshed out the arguments to be made with respect to the issue. There is nothing that would prevent this Court from resolving the conflict regarding the validity of the disputed regulation.

II.

The Third Circuit's Decision Conflicts with Standards of Statutory Interpretation Established by This Court.

There is a strong presumption that Congressional intent is expressed through the statutory language it chooses. The Third Circuit's decision conflicts with this presumption. Congress used the same term, "reserve strengthening," in § 1023(e)(3)(B) of the Act that it used in § 216 of the Deficit Reduction Act of 1984 ("DEFRA"), Pub. L. 98-369, 98 Stat. 494. The meaning of the term when used in DEFRA has never been in dispute. No statutory language was used to differentiate the meaning of the same term two years later in § 1023(e)(3)(B) of the Act. Nevertheless, the Third Circuit held that § 1023(e)(3)(B) is ambiguous. After so holding, the Third Circuit turned to ambiguous legislative history to give deference to a definition in a Treasury regulation of the

term "reserve strengthening" that is inconsistent with the undisputed meaning of the term as used in a predecessor statute.

As noted above, for 1987 and later years the Act significantly changed the way P&C insurers compute reserves for federal income tax purposes by requiring discounting. The Act contained a fresh start provision and an exception from the fresh start provision for "reserve strengthening." With respect to the reserve strengthening exception, § 1023(e)(3)(B) of the Act provides as follows:

> Reserve strengthening in years after 1985. -- [The fresh start] shall not apply to any reserve strengthening in a taxable year beginning in 1986, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December 31, 1986.

While the statute does not expressly define the term "reserve strengthening," there is a plain meaning to be given to that term following the principles of statutory interpretation established by this Court.

Just two years prior to the Act, Congress significantly changed the way in which life insurance companies calculate reserves for federal income tax purposes. DEFRA §§ 201-231. Like the Act, those provisions contained a "fresh start" provision and a "reserve strengthening" exception. DEFRA § 216. In relevant part, DEFRA § 216(b)(3) contains the following reserve strengthening provisions:

> (3) Reinsurance transactions, and reserve strengthening, after September 27, 1983. --

> (A) In general. -- Paragraph (1) [general rule for fresh start adjustment] shall not apply . . .
>
> * * * * *
>
> (ii) to any reserve strengthening reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984.

In this connection, Respondent and the Third Circuit agree that Congress used the term "reserve strengthening" in DEFRA in accordance with life insurance usage -- that is, reserve additions resulting from a change in a method or assumption used in calculating policy reserves.

The term "reserve strengthening" has a comparable meaning in P&C insurance. As the Tax Court stated in *Western National*:

> Generally, increases in a company's reserves are either attributable to (1) normal additions made each year to fund existing and increasing obligations under policies in force; or (2) additions required when a method or assumption used in calculating policy reserves is changed so as to produce higher reserves. The latter or less usual occurrence has been described as reserve strengthening. 102 T.C. at 351.

Indeed, no matter what other conclusions may be drawn from the expert testimony in this case, it is clear that all of

the experts acknowledged that the term "reserve strengthening" has been used in P&C insurance to mean reserve increases resulting from a change in the taxpayer's methodology or assumptions used for calculating loss reserves.

When Congressional intent is clear from reading the statute, "that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of congress." *Chevron U.S.A., Inc., v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984). There is a strong presumption that Congressional intent is expressed through the statutory language it chooses. *See West Virginia University Hospitals, Inc. v. Casey*, 499 U.S. 83, 83 (1991); *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 240-241 (1988); *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571 (1982). This Court has held that when the meaning of a phrase is plain, there is no need for recourse to legislative history. *West Virginia University Hospitals, supra.*

Moreover, Congress is presumed to intend an established meaning of a term when it uses the term, absent an affirmative statement by Congress that clearly and unequivocally indicates that the common meaning is not intended. *See, e.g., Rowan Companies, Inc. v. United States*, 452 U.S. 247 (1981); *United States v. Olympic Radio and Television*, 349 U.S. 232 (1955). In *Rowan*, this Court considered the validity of longstanding regulations relating to the withholding of FICA and FUTA taxes on "wages." The same term, "wages," was also used in the provisions of the Code relating to the withholding of income taxes. The regulations under the income tax provision excluded from "wages" the value of "room, board, etc." provided to an

employee for the convenience of the employer. A similar exclusion was not included in the regulations relating to FICA and FUTA taxes. "Wages" for such taxes were defined by the regulations to include the value of "room, board, etc." even though excluded from "wages" for withholding of income tax.

The taxpayer in *Rowan* argued that "wages" for withholding of FICA and FUTA taxes should have the same meaning as "wages" for income tax withholding. The Commissioner argued that because FICA and FUTA taxes compose a distinct system of taxation, the rules applicable to income taxation did not apply. The Commissioner supported the regulations with selected language from the legislative history to the FICA and FUTA provisions to the effect that "wage[s]... include compensation for services in any other form such as room, board, etc."

This Court rejected the arguments of the Commissioner in *Rowan*, and held the regulations relating to withholding of FICA and FUTA taxes invalid because the term "wages" in the circumstances should not be interpreted as having two meanings. The result followed from a strong presumption in favor of a consistent interpretation of an identical statutory term. This Court was not persuaded by selected language from the legislative history that "could be reconciled with" the regulations in issue.

In this case, the Third Circuit failed to adhere to the *Rowan* principal, and as a consequence, misapplied the principles set forth in *Chevron*. In *Chevron*, this Court held that a court should first examine whether Congress has directly spoken to the question at issue. In applying this first prong of *Chevron*, the Third Circuit failed to recognize that

in the circumstances the *Rowan* principle eliminated the necessity of going beyond the plain meaning of the statute. Thus, when Congress uses a term that was used previously in another statute, Congress is presumed to intend the same meaning as in the previous statute unless there is an unambiguous showing to the contrary.

Here, Congress used a term, "reserve strengthening," that had been used just two years before in a statute relating to a transition from one set of provisions for insurance reserve computation to another. DEFRA § 216. The meaning of the term so used was defined by consistent usage in the insurance industry for more than thirty years. *See, e.g., Western National*, 65 F.3d at 92-93, and authorities cited therein. That meaning was and is not in dispute, and is also consistent with usage in P&C insurance. As the Tax Court concluded in *Western National*:

> [I]n enacting TRA 86 section 1023, Congress could not have expected a different quantitative or qualitative meaning for the term "reserve strengthening," depending upon whether it was used in connection with tax provisions specifically designed for life or P&C companies. The fact that the same terminology was used as was employed in similar legislation 2 years earlier in the same subchapter of the Code creates the presumption that no change in meaning was intended. *Zuanich v. Commissioner*, 77 T.C. 428, n. 26 (1981) (quoting *Dickerson, Interpretation and Application of Statutes*, 224 (1975)). 102 T.C. at 354.

Furthermore, after reciting the prior usage of the term in DEFRA, the Eighth Circuit stated:

> Even if there were no property and casualty industry definition of reserve strengthening, a conclusion we have rejected, we see nothing that would prohibit Congress from appropriating the life insurance standard and applying it to a property and casualty provision of the Code. 65 F.3d at 93.

Nevertheless, the Third Circuit concluded that when the same term was used two years later, its meaning was ambiguous. The Third Circuit failed to identify any language in the Act to indicate that Congress intended a different definition. Instead, it derived an inference from language that is not in the statute and relied on ambiguous legislative history.[2] As established by *Rowan*, this Court requires a clear and unambiguous showing of a contrary intent where the statutory term is identical. As noted by the Tax Court and the Eighth Circuit, neither the Act nor the legislative history provides that clear contrary intent.

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[2]Section 1023(e)(3)(B) of the Senate version of the Act included a sentence apparently patterned on a sentence in § 216 of DEFRA. As used in DEFRA, the sentence applied only to reserve strengthening on contracts issued in 1983. The sentence in DEFRA had no impact on the general definition of reserve strengthening for purposes of that statute. Since the sentence was not inserted to change the general definition of reserve strengthening in DEFRA, the omission of the sentence in the Act cannot properly support the inference drawn by the Third Circuit that Congress intended a change in the general definition of reserve strengthening for purposes of the Act.

In the opinion below, the Third Circuit accepted Respondent's argument that the term "reserve strengthening" has a commonly understood industry meaning in life insurance, but that no such industry-wide definition exists in P&C insurance. In reaching that conclusion, the Third Circuit reasoned:

> We find it illogical to apply the life insurance definition of reserve strengthening to P&C insurers -- whose reserves are not predicated upon the same actuarial assumptions. If we did so apply it, arguably there would never be any reserve strengthening in the P&C area since interest rates, mortality assumptions and methodologies are not underlying components of the P&C loss reserves. 111 F.3d at 1061.

The Third Circuit's assertion regarding the "components" of P&C reserves is without support in the record and flatly wrong.[3] As a result, the Third Circuit incorrectly stated that P&C insurers do not use methodologies and assumptions in calculating reserves. Although the methodologies and assumptions may differ, the general concept of reserves, whether for a life insurer or a P&C insurer, is the same. The calculation of reserves serves one purpose for all insurers, i.e., identifying the amount of the assets required to be held by an insurer to provide for payment of liabilities to policyholders in the future. As the Tax Court observed in *Western National*:

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[3]It is notable that the Third Circuit concluded on the one hand that methodologies and assumptions are not underlying components of P&C loss reserving but on the other hand cited the expert testimony of P&C actuaries whose function is to apply methodologies and assumptions in setting P&C loss reserves.

In the insurance industry a policy reserve represents a liability; i.e., it represents an obligation to the policyholders. Historically, reserves have been described in PC insurance literature as estimated liabilities for losses and loss adjustment expenses. [footnote omitted.] To some extent, loss reserves are estimates extrapolated from past trends, patterns, averages, and inferences and predictions as to the future. Accordingly, "The reserve simply operates as a charge on so much of an insurance company's assets as must be maintained in order for the company to be able to meet its future commitments under the policies it has issued." [footnote omitted.] The general concept of reserves is the same for life and PC insurance companies. 102 T.C. at 350-351.

The calculation of all insurers' reserves is based on methodologies and assumptions. All insurers make routine changes to reserves. In addition, insurers may make non-periodic changes to reserves if the methodologies and assumptions previously used produce inappropriate results.

Ultimately, the legislative history "provides no persuasive rationale for interpreting the statutory term 'reserve strengthening' in a manner different from industry usage." *Western National*, 65 F.3d at 93. Atlantic's position that reserve strengthening does not apply to all increases to reserves comports with the rationale contained in the legislative history for the reserve strengthening exception to the fresh start. Congress intended to permit P&C insurers a fresh start for normal reserve increases, ones that could not

be "artificial" in nature. H.R. Rep. No. 841, 99th Cong. 2d Sess. (1986) at II-367, reprinted in 1986 U. S. Code Cong. & Admin. News at 4455. However, contrary to this legislative history relating to the reserve strengthening provision, the regulation renders the nature of or reason for a reserve increase irrelevant, because it treats any addition to reserves as reserve strengthening. In this connection, it is important to note that Respondent conceded that Atlantic's reserves were reasonable and that the reserves were determined in accord with Atlantic's past practices. Yet, Respondent determined that Atlantic's routine and reasonable reserve increases constituted "reserve strengthening" under the mechanical test adopted in the regulation.

As in *Rowan*, the legislative history in this case is patently ambiguous and is not sufficient to overcome the presumption to be taken from the use by Congress of the identical term just two years before in a closely analogous statute. Had Congress truly intended to preclude a fresh start for all additions to reserves, it would have done so directly and simply by referring to "all reserve increases" or "all reserve additions" in the statute, rather than using the same highly specialized insurance industry term, "reserve strengthening," it had used just two years before.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Dated: July 22, 1997

Respectfully submitted,

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APPENDIX

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UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 96-7424

ATLANTIC MUTUAL INSURANCE COMPANY,
and Includible Subsidiaries

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellant

Appeal from the United States TaxCourt
(Tax Court No. 93-25767)

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111 F.3d 1056;
97-1 U.S. Tax Cas. (CCH) P50,376; 79
A.F.T.R.2d (P-H) 2272

March 13, 1997, Argued
April 24, 1997, Filed

Before: MANSMANN and LEWIS, Circuit Judges,
and MICHEL, Circuit Judge.*

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* Honorable Paul R. Michel of the United States Court of Appeals for the Federal Circuit, sitting by designation.

OPINION OF THE COURT

MANSMANN, *Circuit Judge*.

In this appeal, we address the "fresh start" provision of section 1023(e)(3) of the Tax Reform Act of 1986. There Congress permitted property & casualty insurers a one-time forgiveness of income resulting from the change in computing "losses incurred deductions" from undiscounted to a discounted basis as mandated by newly enacted section 846 of the Internal Revenue Code. Specifically, the Commissioner challenges the decision of the Tax Court which invalidated Treas. Reg. § 1.846-3(c) to the extent that it defines all additions to a property & casualty insurer's loss reserves as "reserve strengthening."

We find that the meaning of the term "reserve strengthening" in section 1023(e)(3)(B) of the Tax Reform Act of 1986 is ambiguous. We thus turn to the legislative history to determine Congress' intent. Utilizing the deference principles of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 81 L. Ed. 2d 694, 104 S. Ct. 2778 (1984), we conclude that Treas. Reg. § 1.846-3(c) is based on a permissible construction of the Act and implements the intent of Congress in some reasonable manner. Accordingly, we will reverse the decision of the Tax Court.

I.

The statutory provision at issue is section 1023 of Pub. L. No. 99-514, 100 Stat. 2085, 2399, of the Tax Reform Act of 1986 (TRA 1986), which added new section 846 of the Internal Revenue Code. In enacting section 846, Congress included two relief provisions--the "transition rule" and the "fresh start"--to facilitate a smooth transition to the new rules. *Atlantic Mutual Insurance Co. v. Commissioner*, 71 T.C.M. (CCH) 2154, 2156, 1996 T.C. Memo 75 (1996). The transition rule, set forth in section 1023(e)(2) of TRA 1986, provided that for purposes of computing the losses incurred deduction for 1987, the year-end 1986 reserves would be discounted.[1] Absent this relief provision, section 846 would have required property & casualty ("P&C") insurers to compare undiscounted 1986 reserves with

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[1] Property & casualty companies are taxed pursuant to I.R.C. §§ 831 through 835. Under section 832(a), the taxable income of such a company is defined as the gross income minus allowable deductions. Section 832(c)(4) provides that these deductions include "losses incurred" as defined in section 832(b)(5). Prior to 1986, section 832(b)(5) defined "losses incurred" for all relevant purposes as the amount of "losses paid" during the year plus the increase (or minus the decrease) in "unpaid losses." In practice, the P&C company would deduct the full amount of the estimated total loss in the year of the loss-event, even though the claim might not be paid for several years. When the claim was paid, the company would not receive any additional deduction (assuming that the payment equalled the original estimate) because the payment would be offset by a corresponding reduction it its unpaid-loss reserve.

Prior to TRA 1986, property & casualty insurers received an unsolicited benefit because the tax laws failed to take into consideration the time value of money in calculating the deduction for losses incurred. Congress addressed this problem by enacting I.R.C. § 846 as part of TRA 1986, which provides for the discounting of unpaid losses. The new discounting rules apply to all taxable years commencing after December 31, 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2404.

discounted 1987 reserves for purposes of computing their losses incurred deductions for 1987. As the Tax Court explained, "Such an 'apples-to-oranges' comparison would have significantly reduced the losses incurred deduction for the 1987 tax year." *Id.*

Notwithstanding the relief provided by the transition rule, P&C insurers were still obligated to include in their 1987 taxable income the excess of the undiscounted year-end 1986 loss reserves over the discounted year-end 1986 loss reserves, due to the application of I.R.C. § 481.[3] To avoid the application of section 481, Congress allowed P&C insurers a one-time "forgiveness" of income under the "fresh start" provision of section 1023(e)(3) of TRA 1986. That section provides:

> (3) Fresh Start.--
>
> (A) In General.--Except as otherwise provided in this paragraph, any difference between--
>
> (i) the amount determined to be the unpaid losses and expenses unpaid for the year preceding the 1st taxable year of an insurance company beginning after December 31, 1986, determined without regard to paragraph (2), [i.e., without discounting] and

[3] Normally, section 481 would require a taxpayer to recognize the excess as income, because the change in the basis for computing losses incurred deductions from an undiscounted to a discounted methodology constitutes a change in accounting method. In this circumstance, I.R.C. § 481 requires the taxpayer to make an appropriate adjustment to prevent it from obtaining a double deduction created by the change in accounting method.

> (ii) such amount determined with regard to paragraph (2) [i.e., with discounting], shall not be taken into account for purposes of the Internal Revenue Code of 1986.

In substance, the fresh start rule overrides section 481 by excluding from taxable income the difference between the amount of the year-end 1986 undiscounted loss reserves and the discounted amount of such reserves.

Congress anticipated, however, the potential for abuse created by the fresh start provision -- that insurers could manipulate the fresh start provision by inflating their reserves. To prevent such abuse, Congress enacted section 1023(e)(3)(B) to exclude any increases in loss reserves due to "reserve strengthening." Section 1023(e)(3)(B) provides:

> (B) RESERVE STRENGTHENING IN YEARS AFTER 1985.--Subparagraph (A) shall not apply to any reserve strengthening in a taxable year beginning in 1986, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December 31, 1986.

The meaning of the term "reserve strengthening," as used in section 1023(e)(3)(B), lies at the heart of the controversy before us. We turn now to the particular facts of this case.

II.

The parties fully stipulated to the following facts before the United States Tax Court. Atlantic Mutual Insurance Co. (Atlantic) is the common parent of an affiliated group of corporations whose principal place of

business is located in Madison, New Jersey. Organized in 1842 under the laws of the State of New York as a mutual marine insurer, Atlantic eventually expanded its insurance underwriting activities to include property & casualty insurance. Centennial Insurance Company, a wholly owned subsidiary of Atlantic, is a P&C insurance company included in Atlantic's consolidated income tax return. The Commissioner's notice of deficiency relates to the activities of both Atlantic and Centennial (collectively the "taxpayer").

From 1985 through 1993, the taxpayer filed annual financial statements with the appropriate state insurance departments.[3] P&C insurers are required to report estimates of amounts they expect to pay for losses that have already occurred on the annual statement. These estimates are commonly referred to as "loss reserves" (or simply "reserves").

For the years in issue, case reserves constituted the majority of the taxpayer's loss reserves.[4] The taxpayer set up

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[3] Each annual statement was prepared in the format prescribed by the National Association of Insurance Commissioners (NAIC) in order to provide state insurance commissioners with information concerning a P&C insurer's financial condition. The accounting principles on which the NAIC-prescribed annual statement is based generally have been incorporated into the Internal Revenue Code sections applicable to P&C insurers.

[4] In its P&C insurance business, the taxpayer maintained three categories of loss reserves: (1) case reserves, which reflect estimates of amounts to be paid to resolve claims that have been reported to the taxpayer; (2) incurred but not yet reported (IBNR) reserves, which consists of estimates of amounts to be paid to resolve claims statistically presumed to have been incurred but not yet reported to the taxpayer; and (3) loss adjustment expense (LAE) reserves, which reflect estimates of administrative costs to be paid in settling or otherwise resolving claims.

its case reserves by assigning a claims adjuster to examine each reported claim and to estimate the amount, if any, that would be paid to resolve it. For all years at issue, the taxpayer's case reserves totalled $255,655,141 at year-end 1985 and $277,705,661 at year-end 1986.

The Commissioner tested for "reserve strengthening" by applying the formula set forth in Treas. Reg. § 1.846-3(c)(3) to each of the taxpayer's lines of P&C insurance for pre-1986 accident years. Under the formula, the taxpayer's reserves at year-end 1985 were reduced by the claims and the loss adjustment expense (LAE) paid in 1986 with respect to those reserves. To the extent that, at year-end 1986, a reserve was greater than the amount determined under the formula, the excess was treated as a net increase to that reserve account (i.e., "reserve strengthening"). Where, at year-end 1986, a reserve was less than the amount determined under the formula, the difference was treated as a net decrease to that reserve account (i.e., "reserve weakening").

The Commissioner determined that, at year-end 1986, the taxpayer's net "reserve strengthening" totalled $6,552,739. Pursuant to I.R.C. § 846, the Commissioner then discounted the $6,552,739, resulting in an understatement of the taxpayer's 1987 income of $1,339,039. The Commissioner further determined that this understatement caused a deficiency of $519,987 in the taxpayer's 1987 income tax liability and, accordingly, issued a Notice of Deficiency on September 23, 1993. In response, the taxpayer petitioned the Tax Court for a redetermination of the deficiency.

After considering all of the evidence, the Tax Court, on February 22, 1996, issued its decision concluding that the taxpayer was not liable for the asserted deficiency. In reaching this conclusion, the Tax Court held the taxpayer's reserve increases did not constitute "reserve strengthening." *Atlantic Mutual*, 71 T.C.M. at 2159. The Tax Court found that the doctrine of stare decisis obligated it to reach the same result as that obtained in *Western National Mutual Ins. Co. v. Commissioner*, 102 T.C. 338 (1994), *aff'd* 65 F.3d 90 (8th Cir. 1995), which the court found to be factually indistinguishable from this case. The Commissioner filed this timely appeal.

We have jurisdiction pursuant to 26 U.S.C. § 7482(a) and we exercise plenary review over a legal challenge to the validity of a treasury regulation. *Tate & Lyle, Inc. v. Commissioner*, 87 F.3d 99, 102 (3d Cir. 1996) (citing *Mazzocchi Bus Co., Inc. v. Commissioner*, 14 F.3d 923, 927 (3d Cir. 1994)).

III.

Initially, we must determine whether the meaning of "reserve strengthening" is clear from the plain language of section 1023(e)(3)(B). Our review of an agency's interpretation of a statute that it is empowered to administer is guided by the well-established principles of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 81 L. Ed. 2d 694, 104 S. Ct. 2778 (1984); see also, *Appalachian States Low-Level Radioactive Waste Commission v. O'Leary*, 93 F.3d 103, 108 (3d Cir. 1996). The two-step inquiry in *Chevron* requires us to first determine "whether Congress has directly spoken to the precise question at issue." 467 U.S. at 842. If the intent of

Congress is clear from the plain language of the statute, then our inquiry ends there. If we conclude, however, that Congress is silent or the statute is ambiguous regarding the issue, then the second step of our inquiry is to determine whether the agency's interpretation is based on a permissible construction of the statute. *Id.* at 843.

Addressing the first prong of *Chevron*, we turn to the plain language of section 1023(e)(3)(B). Clearly absent from the text of the statute is any explanation of the meaning of the term "reserve strengthening." We must determine, therefore, whether Congress intended the meaning of reserve strengthening, as used in the life insurance industry, to apply to P&C insurers. The Tax Court, bound by its previous decision in *Western National* which concluded that reserve strengthening as employed in section 1023(e)(3)(B) is a term of art adopted from the life insurance industry, rejected the Commissioner's argument that the meaning of "reserve strengthening" in the P&C insurance industry is ambiguous. We note the distinction, however, that the Commissioner did not present expert witnesses in *Western National*.

The expert testimony here makes clear that the term "reserve strengthening" as used in section 1023(e)(3)(B) is subject to more than one interpretation.[5] Indeed, the Tax

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[5] The Commissioner and the taxpayer introduced expert reports in the Tax Court proceedings concerning the meaning of "reserve strengthening" within the P&C industry. The taxpayer's first expert, Irene R. Bass, construed "reserve strengthening" as involving "a one-time (or, at least, unusual and non-periodic), significant change in the assumptions and/or methodologies used to compute the reserves which results in a material change to the relative level of adequacy of the total reserve inventory." Bass conceded, however, that "within the context of the reserve setting process, the term reserve strengthening is not a well-defined PC insurance or actuarial term of art to be found in PC

actuarial, accounting, or insurance regulatory literature." She then opined that "the lack of a well recognized definition of reserve strengthening in PC insurance literature can be attributed to the recursive nature of the reserve setting process and the fact that identification of reserve strengthening is not a requirement of the normal process of setting reserves."

The taxpayer's second expert, W. James MacGinnitie, concurred with the expert opinion of Irene Bass. MacGinnitie then described the concept of reserve strengthening in terms of the adequacy of reserves to satisfy future claims, equating adequacy to reserve strengthening and inadequacy to reserve weakening. He further opined that this determination was one that could not be definitively made until all claims covered by the reserves in question had been finally settled. According to MacGinnitie, in order to determine whether reserve strengthening has occurred one must compare the adequacy of the current reserve for a line of business to the adequacy of a previous reserve for that same line of business.

The Commissioner submitted expert reports prepared by Raymond S. Nichols and Ruth Salzmann. In his report, Nichols stated: "In the property-casualty industry the term 'reserve strengthening' has various meanings, rather than a single universal meaning. However, in determining a property-casualty insurer's underwriting income, 'reserve strengthening' generally refers to a positive amount resulting from the difference between calendar year incurred losses and accident year incurred losses." Nichols opined that "any definition of 'reserve strengthening' that restricts the words to the idiosyncrasies of individual company reserve assumptions and methods will miss the impact of reserve strengthening during underwriting cycles. For this reason alone, the common definition of 'reserve strengthening' does not restrict the meaning to changes in reserve assumptions and methods."

Finally, the Commissioner's second expert, Ruth Salzmann, proffered her definition of reserve strengthening:

"Reserve strengthening (or reserve weakening) is a term used in connection with P/C income statements. It refers to the dollar change in the margin of adequacy in the beginning and ending reserves for unpaid losses for that accounting period. The change can be for whatever reason and for any amount. If ending reserves are more adequate (or less

Court in *Western National* commented that the opinions and testimony of the numerous expert witnesses failed to establish a "universal and precise definition of reserve strengthening." 102 T.C. at 351 n.10. The Tax Court nonetheless found that it was able to glean from the expert testimony the conceptual elements of reserve strengthening as they are commonly used in the insurance industry; it concluded that the concept of reserve strengthening has the same meaning in the context of the P&C and life insurance business. *Id.* at 351 n. 10 and 354. We part company with the Tax Court's holding in this regard.

In determining that "reserve strengthening" has the same meaning for both life and P&C insurers, the Tax Court in *Western National* focused on the fact that Congress, in drafting the language of Subchapter L of the Internal Revenue Code, recognized the unique and highly specialized nomenclature of the insurance industry. Moreover, the court observed that "in enacting the fresh-start provision of the DEFRA [Deficit Reduction Act of 1984], Congress used an industry term of art in a manner consistent with its traditional definition" within the life insurance business.[6] 102

inadequate) than the beginning reserves, there is reserve strengthening in the accounting period and net income is understated; conversely, if ending reserves are less adequate (or more inadequate), there is reserve weakening and net income for the accounting period is overstated."

[6] When Congress enacted the fresh start provision for certain life insurance rules in DEFRA, it specifically defined "reserve strengthening" to include only changes in assumptions and methodology. The Commissioner argued that "reserve strengthening" has a different meaning in the P&C insurance industry. In rejecting this argument, the Tax Court "concluded that 'Congress could not have expected a different quantitative or qualitative meaning for the term' depending on the type of insurer." *Atlantic Mutual*, 71 T.C.M. at 2158 (quoting *Western Nat'l*, 102 T.C. at

T.C. at 359. Accordingly, the Tax Court concluded that "reserve strengthening" was a term of art adopted from the insurance industry. Opining that the legislative history contained contradictory explanations and, in part, supported the Commissioner's regulatory position, the Tax Court nonetheless concluded that Congress intended "reserve strengthening" to be interpreted in a manner consistent with industry usage. *Id.* at 360.[7]

The Tax Court's reliance on cases, revenue rulings and legislation involving life insurance reserves is misplaced. For federal income tax purposes, life insurance companies and P&C insurers are taxed in entirely separate manners. Gross income as well as loss reserves are computed on different bases and assumptions. Actuarial assumptions about interest rates and mortality rates are an integral part of

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354).

[7] The Court of Appeals for the Eight Circuit affirmed the decision of the Tax Court, holding that Treas. Reg. § 1.846-3(c) was invalid to the extent that it defines "reserve strengthening" in a manner contrary to industry usage. *Western National Mutual Ins. Co. v. Commissioner*, 65 F.3d 90, 93 (8th Cir. 1995). In reaching this conclusion, the court of appeals opined that Congress intended to deny the fresh start deduction only to those property & casualty companies that computed their 1986 unpaid loss reserves on the basis of methodologies or assumptions that were different from those employed in calculating the same reserves in prior years. *Id.* at 93. As a corollary to this conclusion, the court of appeals also found that the term "reserve strengthening" was not ambiguous. *Id.* (footnote omitted). Accordingly, the court held that it was not required to consider the legislative history to divine the meaning of "reserve strengthening." *Id.* The court of appeals nonetheless proceeded to examine the legislative history, "out of an abundance of caution," and determined that it failed to provide persuasive rationale for interpreting "reserve strengthening" contrary to industry usage. *Id.* We respectfully disagree.

computing future losses which form the basis of the loss reserves in life insurance. On the other hand, P&C loss reserves are determined primarily based on past claims experience and the judgments of the individual claims adjusters.

In the life insurance industry, reserve strengthening constitutes an unusual increase resulting generally from a change in one of the fundamental reserve assumptions (i.e., interest rate, mortality rate, method), as contrasted to normal increases in life insurance reserves, which result from the receipt of additional premiums or accrued interest. We find it illogical to apply the life insurance definition of reserve strengthening to P&C insurers -- whose reserves are not predicated upon the same actuarial assumptions. If we did so apply it, arguably there would never be any reserve strengthening in the P&C area since interest rates, mortality assumptions and methodologies are not underlying components of the P&C loss reserves. The Commissioner makes a persuasive argument that the differences between life insurance and P&C loss reserves "render the wholesale importation of life insurance concepts into the P&C unpaid-loss reserve area quite dubious at best."

The revenue rulings cited by the Tax Court and the taxpayer[8] are inapposite to the issue of reserve strengthening by P&C insurers. These revenue rulings address life insurance reserves maintained by P&C insurers who also write life insurance. In both rulings, the taxpayers requested advice on how to compute life insurance reserves in a given factual situation. The rulings do not define reserve

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[8] Rev. Rul. 65-240, 1965-2 C.B. 236, Rev. Rul. 78-354, 1978-2 C.B. 190.

strengthening with respect to P&C loss reserves in the context of life insurance reserves.

Moreover, we find that the reserve strengthening provision in DEFRA differs from the provision in TRA 1986 and, thus, supports the Commissioner's argument that Congress did not intend to import the life insurance definition of reserve strengthening into section 1023(e)(3)(B). The 1984 statute specifically links reserve strengthening by life insurance companies to changes in the reserve practice used on the most recent annual financial statement. A similar limitation was contained in the Senate amendment to section 1023(e)(3)(B) but was intentionally eliminated by the Conference Committee. The Supreme Court addressed a similar situation involving the RICO statute and held:

> Where Congress includes particular language in one section of a statute, but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion. Had Congress intended to restrict § 1963(a)(1) to an interest in an enterprise, it presumably would have done so expressly as it did in the immediately following subsection (a)(2). * * * The short answer is that Congress did not write the statute that way. We refrain from concluding here that the differing language in the two subsections has the same meaning in each. We would not presume to ascribe this difference to a simple mistake in draftsmanship.

Russello v. United States, 464 U.S. 16, 23-24, 78 L. Ed. 2d 17, 104 S. Ct. 296 (1983). Accordingly, the reserve

strengthening provision of DEFRA does not support the taxpayer's position here.

Given the lack of an explicit statutory definition of reserve strengthening, the conflicting definitions of reserve strengthening provided by the expert witnesses, and our finding that the meaning attributed to reserve strengthening in the life insurance industry is not applicable to P&C insurers, we conclude that the meaning of "reserve strengthening" is ambiguous. Accordingly, we find the Tax Court erred as a matter of law in holding that the meaning of reserve strengthening in section 1023(e)(3)(B) was plain.

IV.

Because we find the meaning of the term "reserve strengthening" ambiguous with regard to P&C insurers, we turn to the second prong of the *Chevron* inquiry. In so doing, we are required to take a deferential approach to ascertaining whether the agency's interpretation is a permissible one. *Appalachian States Low-Level Radioactive Waste Commission v. O'Leary*, 93 F.3d at 110. Thus, "we must determine 'whether the regulation harmonizes with the plain language of the statute, its origin, and purpose. So long as the regulation bears a fair relationship to the language of the statute, reflects the views of those who sought its enactment, and matches the purpose they articulated, it will merit deference.'" *Id.* (quoting *Sekula v. F.D.I.C.*, 39 F.3d 448, 452 (3d Cir. 1994)).

We begin our analysis by turning to the legislative history of section 1023(e)(3)(B). The provision requiring P&C insurers to discount their loss reserves originated in a House bill. H.R. 3838, 99th Cong., 1st Sess., § 1021-1027

(1985). In the Senate version, the provision was amended to include the fresh start provision as well as the exclusion for reserve strengthening. The pertinent language of the Senate bill states:

> (3) FRESH START.--
>
> (A) IN GENERAL.--Except as otherwise provided in this paragraph, any difference between the amount determined to be the unpaid losses and expenses unpaid for the year preceding the first taxable year of an insurance company beginning after December 31, 1986, determined without regard to paragraph (2), and such amount determined with regard to paragraph (2), shall not be taken into account for purposes of the Internal Revenue code of 1954.
>
> (B) RESERVE STRENGTHENING AFTER MARCH 1, 1986. [The fresh start provision] shall not apply to any reserve strengthening reported for Federal income tax purposes after March 1, 1986, for a taxable year beginning before January 1, 1987, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December 31, 1986. *The preceding sentence shall not apply to the computation of reserves on any contract if such computation employs the reserve practice used for purposes of the most recent annual statement filed on or before March 1, 1986, for the type of contract with respect to which reserves are set up.*

H.R. 3838, 99th Cong., 2d Sess., § 1022(e) (as reported by the Senate Finance Committee, May 29, 1986) (emphasis

added). The Senate Finance Committee explained this provision as follows:

> Any reserve strengthening after March 1, 1986, is to be treated as reserve strengthening for the first taxable year beginning after December 31, 1986. The committee intends that any adjustments to reserves that are attributable to changes in reserves on account of changes in the basis for computing the reserves (i.e., reserve strengthening or reserve weakening) in a taxable year beginning before January 1, 1987, are not taken into account in determining taxable income after the effective date.

S. Rep. No. 99-313, 1986-3 C.B. (Vol. 3) 510.

The Conference Committee reconciled the differences between the House and Senate versions of H.R. 3838 by eliminating the last sentence of the Senate amendment (section 1022(e)(3)(B)) that linked reserve strengthening to changes in reserve setting practices. Although the final bill did not define "reserve strengthening," the Conference Committee report accompanying the final bill did, in fact, provide a definition of that term. The Conference Committee's definition, which was more expansive than that contained in the Senate Finance Committee report, reads as follows:

> Reserve strengthening is considered to include all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year (taking into account claims paid with respect to that accident year), and all additions to reserves resulting from a change in the

> assumptions (other than changes in assumed interest rates applicable to reserves for the 1986 accident year) used in estimating losses for the 1986 accident year, as well as all unspecified or unallocated additions to loss reserves. This provision is intended to prevent taxpayers from artificially increasing the amount of income that is forgiven under the fresh start provision.

H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess., at II-367 (1986), reprinted in 5 U.S.C.C.A.N. 4075, 4455 (1986).[9] Further evidence of the Conference Committee's expansion of the definition of reserve strengthening is found in Senator Wallop's criticism of the Committee's action:

> Presumably, the intent is to prevent insurers from artificially increasing the opening reserve in order to increase income forgiven under fresh start. Implicit in this provision is the notion that reserve strengthening actions taken by insurance companies during 1986 for prior accident years is heavily motivated by the desire to avoid Federal income taxes. Nothing could be further from the truth. While it certainly can be acknowledged that increases in reserves decrease an insurance company's Federal tax burden, there are substantial and legitimate nontax

[9] The Tax Court here acknowledged that the Conference Committee's definition of reserve strengthening was more expansive than that contained in the Finance Committee report. *Atlantic Mutual*, 71 T.C.M. at 2157.

> reasons[10] for increasing the provision for unpaid losses in prior accident years. . . .
>
> . . .
>
> The reserve strengthening definition as currently written in the conference report is arbitrary and inconsistent with one of the goals of tax reform, that is, fostering positive behavioral response from corporate and individual taxpayers toward the Federal tax system.
>
> The Senate bill's reserve strengthening provision was fair. The Internal Revenue Service, as it does under current law, would combat abusive reserving practices. The conference modification substitutes a simplistic, cookbook approach that is entirely inappropriate and will likely create tensions causing companies to underreserve to the potential detriment of their policyholders.

132 Cong. Rec. 32625 (daily ed. October 16, 1986).

[10] Senator Wallop offered two legitimate nontax reasons for increasing reserves: (1) reserves are based on estimates computed from statistical models that are subject to error and, thus, must be reevaluated from time to time; and (2) P&C insurers have historically been underreserved and reserve strengthening for them occurs is as a normal part of doing business.

Treas. Reg. § 1.846-3(c) (1992),[11] which is predicated on the definition of "reserve strengthening" set forth in the Conference Committee report, provides in pertinent part:

> **(c) Rules for determining the amount of reserve strengthening (weakening)--(1) In general.** The Amount of reserve strengthening (weakening) is the amount that is determined under paragraph (c)(2) or (3) to have been added to (subtracted from) an unpaid loss reserve in a taxable year beginning in 1986. For purposes of [the fresh start], the amount of reserve strengthening (weakening) must be determined separately for each unpaid loss reserve by applying the rules of this paragraph (c). This determination is made without regard to the reasonableness of the amount of the unpaid loss reserve and without regard to the taxpayer's discretion, or lack thereof, in establishing the amount of the unpaid loss reserve. The amount of reserve strengthening for an unpaid loss reserve may not exceed the amount of the reserve, including any undiscounted strengthening amount, as of the end of the last taxable year beginning before January 1, 1987. For purposes of this section, an "unpaid loss reserve" is the aggregate of the unpaid loss estimate for losses (whether or not reported) incurred in an accident year of a line of business.

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[11] In 1988, the IRS issued a notice of forthcoming regulations regarding the application of section 1023(e)(3)(B). I.R.S. Notice 88-100, 1988-2 C.B. 439. Proposed regulations were issued in 1991, Proposed Treas. Reg. § 1.846-3, 56 F.R. 20161 (May 2, 1991), and eventually, final regulations were promulgated on September 4, 1992.

. . .

> **(3) Accident years before 1986--(i) In general.** For each taxable year beginning in 1986, the amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 is the amount by which the reserve at the end of that taxable year exceeds (is less than)--
>
> (A) The reserve at the end of the immediately preceding taxable year; reduced by
>
> (B) Claims paid and loss adjustment expenses paid ("loss payments") in the taxable year beginning in 1986 with respect to losses that are attributable to the reserve. . . .

In the explanation accompanying the final regulations, the IRS noted its reason for not adopting the commentators' suggested alternatives to the mechanical test:

> Congress did not limit the imposition of the reserve strengthening rule to tax motivated transactions. The legislative history indicates that for purposes of the fresh start adjustment the term "reserve strengthening" includes "all additions to reserves attributable to an increase in an estimate of reserves established for a prior accident year (taking into account claims paid with respect to that accident year), and all additions to reserves resulting from a change in the assumptions (other than changes in the assumed interest rates applicable to reserves for the 1986 accident year) used in estimating losses for the 1986 accident year, as well as all unspecified or

> unallocated additions to loss reserves". See 2 H.R. Conf. Rep. 841, 99th Cong., 2d Sess. II-367 (1986), 1986-3 (Vol. 4) C.B. 367. Thus, Congress adopted an expansive and mechanical definition of reserve strengthening that is reflected in the final regulations.

1992-2 C.B. 146, 148.

A close examination of Treas. Reg. § 1.846-3(c)(3) reveals that virtually all additions to reserves constitute reserve strengthening. The regulation also contains two narrow exceptions, neither of which applies here. The regulation can be reconciled with the Conference Committee's description of reserve strengthening which is all-inclusive: "all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year (taking into account claims paid with respect to that accident year). . . ." H.R. Conf. Rep. No. 99-841. As it applies to reserve strengthening for pre-1986 accident years, Treas. Reg. § 1.846-3(c) does not contradict the Conference explanation and is somewhat more generous to the taxpayer by providing two, albeit narrow, exceptions.

Our remaining inquiry is whether the regulation harmonizes with the articulated purpose of section 1023(e)(3)(B). The purpose of the reserve strengthening exception, as articulated by the Conference Committee, is "to prevent taxpayers from artificially increasing the amount of income that is forgiven under the fresh start provision." The Commissioner and the taxpayer disagree as to the meaning to be ascribed to the Committee's use of the word "artificially" in delineating the purpose of the limitation. This dispute stems from the Tax Court's statement, in *Western National*, that the word "artificial" suggests a

dichotomy between routine, normal additions to reserves and irregular or nonperiodic increases attributable to changes in actuarial assumptions or methodology. The Tax Court's analysis, however, cannot be reconciled with the Conference Committee's broad definition of reserve strengthening which includes normal additions. Thus, the Conference Committee used the term "artificial" in a general sense, to refer to any increases in the reserves other than those resulting from the difference attributed to the discounting of reserves. To accept the Tax Court's construction of "artificial" would mean that the Conference Committee intentionally contradicted itself one sentence later.

In light of the above discussion, we cannot say that Treas. Reg. § 1.846-3(c)(3) is inconsistent with Congress' intent, as evidenced by the Conference report. Accordingly, we find that Treas. Reg. § 1.846-3(c) meets the second prong of the *Chevron* test and, thus, constitutes a valid interpretation of section 1023(e)(3)(B).

The taxpayer makes several arguments[12] suggesting that the application of the Treasury regulation will cause anomalous results. These involve unrealistic assumptions about the size and number of claims. We agree with the Commissioner that, to the extent the mechanical test is

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[12] The taxpayer further contends that despite numerous comments during the promulgation process as to the proposed regulation's infirmities, the Commissioner went forward in adopting a mechanical test for determining the amount of reserve strengthening. In particular, the taxpayer takes issue with the test's reserve-by-reserve approach as opposed to a claim-by-claim calculation. The Conference Report, however, supports a reserve-by-reserve approach ("all additions to *reserves* attributable to an increase in an estimate of a *reserve* established for a prior accident year.") (emphasis added).

flawed, the taxpayer should seek relief from Congress and not the courts. "Judges cannot override the specific policy judgments made by Congress in enacting the statutory provisions with which we are here concerned." *United States v. Sotelo*, 436 U.S. 268, 279, 56 L. Ed. 2d 275, 98 S. Ct. 1795 (1978). We must not focus on the Act's policy, but rather, on what Congress intended in enacting the statute.[13] *Id.* at 280.

The Treasury Department considered proposed alternatives to Treas. Reg. § 1.846-3 but ultimately concluded that the interpretation was consistent with Congress' intent. As the Supreme Court observed in *United States v. Correll*, 389 U.S. 299, 306-07, 19 L. Ed. 2d 537, 88 S. Ct. 445 (1967):

> Alternatives to the Commissioner's . . . rule are of course available. Improvements might be imagined. But we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing "all needful rules and regulations for the enforcement" of the Internal Revenue Code. In this area of limitless factual variations, "it is the province of Congress and the

[13] We agree with the Commissioner that the regulation need not provide the "perfect solution in every case to be valid." Indeed, in *Mourning v. Family Publications Services, Inc.*, 411 U.S. 356, 371, 36 L. Ed. 2d 318, 93 S. Ct. 1652 (1973), the Court held the fact that another remedial provision might be preferred irrelevant to determining whether the agency overstepped its authority. The Court stated: "We have consistently held that where reasonable minds may differ as to which of several remedial measures should be chosen, courts should defer to the informed experience and judgment of the agency to whom Congress delegated appropriate authority." *Id.* at 371-72 (citations omitted).

> Commissioner, not the courts, to make the appropriate adjustments." The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner.

(footnote and citation omitted). Because Treas. Reg. § 1.846-3(c) implements the intent of Congress in some reasonable manner, the Tax Court erred in holding that the regulation was invalid.

V.

For the reasons set forth above, we will reverse the decision of the Tax Court.

UNITED STATES TAX COURT

Docket No. 25767-93.

ATLANTIC MUTUAL INSURANCE COMPANY AND INCLUDIBLE SUBSIDIARIES,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

T.C. Memo 1996-75;
71 T.C.M. (CCH) 2154

February 22, 1996, Filed

MEMORANDUM OPINION

FOLEY, Judge: Respondent determined a deficiency of $519,987 in petitioners' Federal income tax for the 1987 taxable year as a result of alleged "reserve strengthening". Under the Tax Reform Act of 1986 (TRA '86), Pub. L. 99-514, sec. 1023, 100 Stat. 2085, 2404, any increases in the loss reserves maintained by property and casualty insurance companies that constitute "reserve strengthening" do not qualify for a one-time tax benefit. In this case, respondent contends that the term "reserve strengthening" refers to all increases in loss reserves, while petitioners maintain that the term refers to only those increases in loss reserves that are attributable to changes in computation methods or assumptions. Respondent's interpretation of the term "reserve

strengthening" is set forth in section 1.846-3(c), Income Tax Regs. The deficiency in this case is based on that regulation. In light of this Court's decision in *Western Natl. Mut. Ins. Co. v. Commissioner*, 102 T.C. 338 (1994), affd. 65 F.3d 90 (8th Cir. 1995), we hold for petitioners.

Background

The facts have been fully stipulated under Rule 122 of the Tax Court Rules of Practice and Procedure and are so found. Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the year in issue.

Atlantic Mutual Insurance Co. (Atlantic) is the common parent of an affiliated group of corporations within the meaning of section 1504(a). Atlantic filed consolidated income tax returns on behalf of the group for all relevant years. At the time the petition in this case was filed, Atlantic's principal place of business was in Madison, New Jersey.

Atlantic was organized in 1842 under the laws of the State of New York as a mutual marine insurer. Over the years, Atlantic has expanded its insurance underwriting activities to include most lines of insurance business available to a property and casualty (P&C) insurer. Centennial Insurance Co. (Centennial), a wholly owned subsidiary of Atlantic, is a P&C insurance company included in Atlantic's consolidated return. Because respondent's notice of deficiency relates to the activities of both Atlantic and Centennial, we will refer to the two corporations together as petitioner.

From 1985 through 1993, petitioner filed an annual statement with the insurance department of each State in which petitioner was licensed to conduct insurance business. Each annual statement was prepared in the format prescribed by the National Association of Insurance Commissioners (NAIC). A primary purpose of the annual statement is to provide State insurance commissioners with information concerning a P&C insurer's financial condition. The accounting principles on which the NAIC-prescribed annual statement is based generally have been incorporated into the Internal Revenue Code sections applicable to P&C insurers.

On the annual statement, P&C insurers are required to report estimates of amounts they expect to pay to cover losses that have already occurred. These estimates are commonly referred to as "loss reserves" (or simply "reserves"). Petitioner maintained three categories of loss reserves: (1) Case reserves, which reflect estimates of amounts to be paid to resolve claims that have been reported to petitioner; (2) incurred but not yet reported (IBNR) reserves, which reflect estimates of amounts to be paid to resolve claims statistically presumed to have been incurred but not yet reported to petitioner; and (3) loss adjustment expense (LAE) reserves, which reflect estimates of administrative costs to be paid in settling or otherwise resolving claims. For the years in issue, case reserves constituted the majority of petitioner's loss reserves.

Petitioner established its case reserves by assigning a claims adjuster to examine each reported claim and estimate the ultimate amount, if any, that would be paid to resolve it. Case reserves simply comprised the aggregate of those estimates. Overall, petitioner's case reserves totaled

$255,655,141 at yearend 1985 and $277,705,661 at yearend 1986.

Petitioner established its IBNR reserves by applying a "counts and averages" methodology to each line of insurance business. Under this method, petitioner computed its IBNR reserves by multiplying (1) the number of claims that it presumed would be reported after the accident year by (2) the average cost it projected to resolve each late-reported claim. Petitioner based its estimate of these numbers on its experience in prior accident years and then adjusted the results to reflect actuarial quarterly reviews of the loss reserves for the preceding year. Senior management had discretion in determining the size of the adjustments. Management made downward adjustments to petitioner's IBNR reserves of $1,200,000 for 1985 and $100,000 for 1986. Overall, petitioner's IBNR reserves totaled $93,713,687 at yearend 1985 and $111,708,986 at yearend 1986.

Petitioner established its LAE reserves through a combination of individual case estimates, formulas, and judgmental factors. To arrive at an estimate of LAE reserves, petitioner calculated the ratio of LAE it paid during a preceding 3-year period to total losses it paid during the same period and used that ratio as a component in certain formulas. Petitioner maintained two categories of LAE reserves: (1) Allocated loss adjustment expenses (ALAE), which consisted of expenses assignable to individual claims (e.g., legal fees and costs), and (2) unallocated loss adjustment expenses (ULAE), which consisted of expenses not assignable to individual claims (e.g., rent allocable to the claims department). Petitioner used different formulas to compute each category of its LAE reserves. Petitioner's

management then adjusted the ALAE (but not the ULAE) estimate based on quarterly loss and LAE reviews. Overall, petitioner's LAE reserves totaled $72,317,450 at yearend 1985 and $84,066,519 at yearend 1986.

Respondent tested for "reserve strengthening" by applying the formula set forth in section 1.846-3(c)(3), Income Tax Regs., to each of petitioner's lines of insurance business for pre-1986 accident years. Under the formula, petitioner's reserves at yearend 1985 were reduced by the claims and the LAE paid in 1986 with respect to those reserves. To the extent that, at yearend 1986, a reserve was greater than the amount determined under the formula, the excess was treated as a net increase to that reserve account (i.e., "reserve strengthening"). To the extent that, at yearend 1986, a reserve was less than the amount determined under the formula, the difference was treated as a net decrease to that reserve account (i.e., "reserve weakening").

Respondent determined that, at yearend 1986, petitioner's "reserve strengthening" totaled the following amounts:

Line of Business	Reserve Strengthening (Weakening)
Auto liability	($10,559,423)
Other liability	(1,279,374)
Workers' compensation	4,691,659
Multiple peril	15,585,877
Schedule O[1] (1985)	(3,870,000)
Schedule O (pre-1985)	1,984,000
Net total	6,552,739

[1] Schedule O, a part of the annual statement filed with the National Association of Insurance Commissioners, contains combined loss data on several lines of insurance business with respect to which claims are filed and settled within a relatively short period.

Respondent then discounted, pursuant to section 846, the amount determined as "reserve strengthening" in order to calculate the effect on petitioner's gross income[1]. After discounting the amounts shown in the foregoing chart, respondent determined that petitioner understated its 1987 income as follows:

[1] For a discussion of sec. 846 and discounting generally, see sec. I.A., "The Change from Undiscounted to Discounted Reserve Accounting", in the Discussion section of this opinion.

Line of Business	Income Adjustment
Auto liability	($1,211,842)
Other liability	(309,970)
Workers' compensation	1,211,652
Multiple peril	1,783,897
Schedule O (1985)	(239,446)
Schedule O (pre-1985)	104,748
Net total	1,339,039

Respondent further determined that this $1,339,039 understatement of petitioner's 1987 income resulted in a $519,987 understatement of petitioner's 1987 income tax liability.

Discussion

I. *Overview*

TRA '86 substantially revised the rules that govern the taxation of P&C insurance companies by requiring P&C insurers to discount loss reserves for purposes of section 832(b)(5) (discussed below). The change from undiscounted to discounted methodology eliminated a tax benefit attributable to the time value of money. It also required taxpayers to change their accounting methods. To facilitate a smooth transition to the new rules, Congress included two relief provisions in the legislation--the "transition rule" and the "fresh start".

A. *The Change From Undiscounted to Discounted Reserve Accounting*

Section 832(c)(4) permits P&C insurers to deduct "losses incurred", as defined in section 832(b)(5), in each taxable year. Under section 832(b)(5), losses incurred are defined as the excess of (1) the sum of (a) losses paid during the current tax year and (b) yearend reserves in the current tax year over (2) yearend reserves in the preceding tax year. Prior to 1986, section 832 provided P&C insurers with a significant tax benefit. It permitted them to take current deductions for future payments without requiring them to make any adjustments for the time value of money. To eliminate this benefit, TRA '86 added section 846. Section 846 requires reserves for taxable years beginning after December 31, 1986, to be discounted and thus reduces the losses incurred deduction (as calculated under section 832(b)(5)) to reflect the time value of money.

Without a relief provision, section 846 would have required P&C insurers to compare undiscounted 1986 reserves with discounted 1987 reserves for purposes of computing their losses incurred deductions for 1987. Such an "apples-to-oranges" comparison would have significantly reduced the losses incurred deduction for the 1987 tax year. To illustrate, assume a P&C insurer had loss reserves of $100 million at the end of 1986 and $125 million at the end of 1987. But for section 846, the losses incurred deduction attributable to unpaid losses would have been $25 million (i.e., $125 million - $100 million). If pursuant to section 846 the $125 million of reserves at the end of 1987 were discounted to $110 million, the P&C insurer's losses incurred deduction would have been reduced from $25 million to $10 million (i.e., $110 million - $100 million).

To address this problem, Congress included a transition rule in TRA '86. The transition rule provided that, for purposes of computing the losses incurred deduction at yearend 1987, 1986 reserves also would be discounted. TRA '86 sec. 1023(e)(2), 100 Stat. 2404. As a result of this transition rule, discounted 1987 reserves were compared with discounted 1986 reserves in computing the losses incurred deduction for the 1987 taxable year.

B. *The Application of Section 481*

Even with the transition rule described above, P&C insurance companies remained subject to adverse tax consequences due to the application of section 481. When a taxpayer changes its method of accounting, section 481 generally requires that the taxpayer make adjustments to prevent amounts from being duplicated in or omitted from its taxable income. Compliance with the requirement that P&C insurers change the basis for computing their losses incurred deductions from an undiscounted to a discounted methodology constituted a change in accounting method. Thus, section 481 would have required P&C insurers to recognize as income the difference between (1) the undiscounted amount of loss reserves, as of yearend 1986, included in the computation of the losses incurred deduction for 1986 and (2) the discounted amount of such loss reserves.

To avoid triggering section 481 adjustments, Congress provided P&C insurers with a "fresh start" pursuant to section 1023(e)(3) of TRA '86. TRA '86 sec. 1023(e)(3)(A), 100 Stat. 2404. This section provides as follows:

(3) Fresh start.--

(A) In general.--Except as otherwise provided in this paragraph, any difference between--

(i) the amount determined to be the unpaid losses and expenses unpaid for the year preceding the 1st taxable year of an insurance company beginning after December 31, 1986, determined without regard to paragraph (2) [i.e., without discounting], and

(ii) such amount determined with regard to paragraph (2) [i.e., with discounting], shall not be taken into account for purposes of the Internal Revenue Code of 1986.

In essence, the fresh start provision overrode section 481 by excluding from taxable income the difference between the amount of the yearend 1986 undiscounted loss reserves and the discounted amount of such reserves. In its report, the Committee of Conference (conference committee) described the effect of the fresh start provision as a "forgiveness of income". H. Conf. Rept. 99-841 (Vol. II), at II-367 (1986), 1986-3 C.B. (Vol. 4) 1, 367.

The fresh start provision, however, created the potential for abuse. Because the difference between the undiscounted and discounted loss reserves as of yearend 1986 is excluded from taxation, P&C insurers could manipulate the fresh start provision by inflating their reserves. To prevent this abuse, Congress excluded "reserve strengthening" from the fresh start.

TRA '86, however, did not define "reserve strengthening". Generally, a P&C insurer's loss reserves may increase due to either of two factors: (1) Additions required to fund existing and increasing obligations under policies in force, or (2) additions required when a method or assumption used in calculating reserves is changed to produce higher reserves. As discussed in more detail below, respondent argues that "reserve strengthening" encompasses both types of additions, while petitioner contends that the term refers solely to additions resulting from changes in reserving methods or assumptions.

II. *The Statute, Legislative History, and Regulations*

The House of Representatives initiated the provision requiring P&C insurers to discount their loss reserves. H.R. 3838, 99th Cong., 1st Sess. secs. 1021-1027 (1985). The Senate amended the House's proposal to include both (1) the fresh start provision and (2) the exclusion of "reserve strengthening" from the fresh start. See S. Rept. 99-313, at 510 (1986), 1986-3 C.B. (Vol. 3) 1, 510. Ultimately, the conference committee substantially revised the "reserve strengthening" language contained in both the Senate bill and in the accompanying Senate Finance Committee report.

The Senate bill contained the following provision:

> (B) Reserve Strengthening After March 1, 1986.--
> * * * [the fresh start provision] shall not apply to any reserve strengthening reported for Federal income tax purposes after March 1, 1986, for a taxable year beginning before January 1, 1987, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December

> 31, 1986. The preceding sentence shall not apply to the computation of reserves on any contract if such computation employs the reserve practice used for purposes of the most recent annual statement filed on or before March 1, 1986, for the type of contract with respect to which such reserves are set up. [H.R. 3838, 99th Cong., 2d Sess., sec. 1022(e)(3)(B), as reported by the Senate Finance Committee on May 29, 1986.]

The Finance Committee report stated that "reserve strengthening" consisted of "any adjustments to reserves that are attributable to changes in reserves on account of changes in the basis for computing reserves (i.e., reserve strengthening or reserve weakening) in a taxable year beginning before January 1, 1987". S. Rept. 99-313, *supra* at 510, 1986-3 C.B. (Vol. 3) at 510.

The differences between the House and Senate versions of H.R. 3838 were reconciled by the conference committee. The final bill adopted by the conference committee and enacted into law did not define "reserve strengthening". It provided as follows:

> (B) Reserve Strengthening In Years After 1985.--
> * * * [the fresh start provision] shall not apply to any reserve strengthening in a taxable year beginning in 1986, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December 31, 1986. [H. Conf. Rept. 99-841 (Vol. I), at I-338 (1986), 1986-3 C.B. (Vol. 1) 1, 321.]

The conference committee report accompanying the final bill, however, did provide a definition of "reserve strengthening" and, in fact, provided a more expansive definition of the term than that contained in the Finance Committee report. The conference committee report stated:

> Reserve strengthening is considered to include all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year (taking into account claims paid with respect to that accident year), and all additions to reserves resulting from a change in the assumptions (other than changes in assumed interest rates applicable to reserves for the 1986 accident year) used in estimating losses for the 1986 accident year, as well as all unspecified or unallocated additions to loss reserves. This provision is intended to prevent taxpayers from artificially increasing the amount of income that is forgiven under the fresh start provision. [H. Conf. Rept. 99-841 (Vol. II), *supra* at II-367, 1986-3 C.B. (Vol. 4) at 367.]

In 1992, the U.S. Treasury Department issued regulations under section 846 that are based upon the definition of "reserve strengthening" contained in the conference committee report. Section 1.846-3(c), Income Tax Regs., provides in relevant part:

> (c) Rules for determining the amount of reserve strengthening (weakening).--(1) In general. The amount of reserve strengthening (weakening) is the amount that is determined under paragraph (c)(2) or (3) to have been added to (subtracted from) an unpaid loss reserve in a taxable year beginning in

> 1986. For purposes of * * * [the fresh start], the amount of reserve strengthening (weakening) must be determined separately for each unpaid loss reserve by applying the rules of this paragraph (c). This determination is made without regard to the reasonableness of the amount of the unpaid loss reserve and without regard to the taxpayer's discretion, or lack thereof, in establishing the amount of the unpaid loss reserve. The amount of reserve strengthening for an unpaid loss reserve may not exceed the amount of the reserve, including any undiscounted strengthening amount, as of the end of the last taxable year beginning before January 1, 1987. For purposes of this section, an "unpaid loss reserve" is the aggregate of the unpaid loss estimates for losses (whether or not reported) incurred in an accident year of a line of business.
>
> * * * * * * *
>
> (3) Accident years before 1986. (i) In general. For each taxable year beginning in 1986, the amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 is the amount by which the reserve at the end of the taxable year exceeds (is less than)--
>
> (A) The reserve at the end of the immediately preceding taxable year; reduced by
>
> (B) Claims paid and loss adjustment expenses paid ("loss payments") in the taxable year beginning in 1986 with respect to losses that are attributable to the reserve. * * *

III. *The Western National Decision*

In *Western Natl. Mut. Ins. Co. v. Commissioner*, 102 T.C. 338 (1994), a Court-reviewed decision, this Court considered facts virtually identical to those presented in this case. The Court ruled for the taxpayer, holding that section 1.846-3(c), Income Tax Regs., is invalid to the extent that it treats all net additions in 1986, to pre-1986 loss reserves, as "reserves strengthening". As in the present case, the taxpayer in *Western National* had a higher loss reserve balance, for pre-1986 years, at yearend 1986 than at yearend 1985, but had not changed its reserve assumptions or methodology in computing that balance. The Commissioner argued that all increases in reserves constituted "reserve strengthening" and that the taxpayer's increase therefore should have been excluded from the fresh start. In rejecting the Commissioner's position, the Court cited the following six factors:

> (1) The statute is not ambiguous and uses a term of art in a portion of the Internal Revenue Code which has been specially designed for a particular industry and generally contains industry jargon; (2) the legislative history materials are internally contradictory in that there are references to all increases to reserves and explanations regarding artificial increases or a specific type of increase; (3) the regulatory definition of the term "reserve strengthening" does not comport with insurance industry usage; (4) the regulatory definition of the term "reserve strengthening" does not harmonize with its congressional use 2 years earlier in related and parallel statutes involving life, rather than PC, insurance companies; (5) the regulatory approach

> would result in anomalous results; and (6) the traditional industry definition of the term comports with the concept that Congress was attempting to limit any attempts by taxpayers to take advantage of the fresh-start provisions by means of artificial increases to reserves. * * * *[Id.* at 360-361.]

The Court placed particular emphasis on several of these factors. It stated that subchapter L, which sets forth rules governing the taxation of insurance companies, "is a highly specialized portion of the Internal Revenue Code which is replete with the unique nomenclature of the insurance industry." *Id.* at 342-343. The Court acknowledged that the statute did not provide a definition of "reserve strengthening" but found that the term refers to "a change in the formula or mechanism for calculating a reserve". *Id.* at 352. Moreover, the Court noted, Congress had defined the term as including only changes in assumptions or methodology when it enacted certain life insurance rules and a fresh start provision in the Deficit Reduction Act of 1984, Pub. L. 98-369, sec. 216(b), 98 Stat. 494, 758. *Id.* at 353. In rejecting the Commissioner's argument that "reserve strengthening" has a different meaning in the P&C insurance industry than in the life insurance industry, the Court concluded that "Congress could not have expected a different quantitative or qualitative meaning for the term" depending on the type of insurer. *Id.* at 354.

Although section 1.846-3(c), Income Tax Regs., provided a definition of "reserve strengthening" consistent with the conference committee report, the Court in essence concluded that priority must be accorded to the statute, which "contains a term of art used in an unconditional manner." *Id.* at 355. Moreover, the Court noted, the

conference committee report states that the fresh start was "intended to prevent taxpayers from artificially increasing the amount of income that is forgiven". *Id.* at 356 n.19 (quoting H. Conf. Rept. 99-841 (Vol. II), *supra* at II-367, 1986-3 C.B. (Vol. 4) at 367). The Court concluded that the word "artificially" refers to changes in assumptions or methodology. *Id.* By contrast, the taxpayer in *Western National* merely had made routine adjustments to its loss reserves based on its past reserving practices. *Id.* at 357.

The Court of Appeals for the Eighth Circuit affirmed the Tax Court's decision in *Western National*. It concluded that the term "reserve strengthening" when used in the life insurance industry refers to reserve increases attributable to changes in computational methods or assumptions. *Western Natl. Mut. Ins. Co. v. Commissioner*, 65 F.3d 90, 92-93 (8th Cir. 1995). The court rejected the Commissioner's argument that the term's meaning in the P&C insurance industry is ambiguous. *Id.* at 93. Having decided that the meaning of "reserve strengthening" is clear in the industry, the court further concluded that the legislative history underlying the provision is not controlling. *Id.* Nevertheless, the court stated that it had reviewed the legislative history "out of an abundance of caution" and found "'no persuasive rationale for interpreting the statutory term "reserve strengthening" in a manner different from industry usage.'" *Id.* (quoting *Western Natl. Mut. Ins. Co. v. Commissioner*, 102 T.C. at 355).

IV. *Respondent's Position*

Respondent urges this Court to reconsider its holding in *Western National*. Respondent in the present case, as in *Western National*, maintains that "reserve strengthening"

encompasses all net additions in 1986 to pre-1986 loss reserves. Respondent acknowledges that, in the life insurance industry, the term "reserve strengthening" has the meaning petitioner ascribes to it. Respondent continues to contend, however, that the term's meaning in the P&C insurance industry is ambiguous.

Respondent has presented expert testimony which indicates that the term is subject to more than one interpretation. One expert opined that the regulation's definition provided a valid measurement of "reserve strengthening". Another expert opined that the regulation's definition, while not technically accurate, was consistent with a common usage of the term in nonactuarial reporting. Moreover, respondent notes that the conference committee report's definition of "reserve strengthening" is fully consistent with her position. The report stated:

> Reserve strengthening is considered to include *all* additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year * * * and *all* additions to reserves resulting from a change in the assumptions * * * as well as *all* unspecified or unallocated additions to loss reserves. * * * [H. Conf. Rept. 99-841 (Vol. II), *supra* at II-367, 1986-3 C.B. (Vol. 4) at 367; emphasis added.]

Respondent also addresses two points made in *Western National* regarding the legislative history of "reserve strengthening". First, respondent argues that the Court's view--that the conference committee report "conflicts" with other portions of the legislative history--does not take into account the evolution of the

statute. Conference committees reconcile differences between House and Senate versions of legislation and write the final legislation that is enacted into law. In respondent's view, therefore, the decision of the conference committee to reject the language contained in the Senate report does not create a "conflict" but instead provides the rationale for the final legislation.

Second, respondent addresses the Court's concern that the conference committee's definition of "reserve strengthening" is internally contradictory. The Court found that the conference committee's definition of the term is "broader than necessary to accomplish the stated purpose of preventing abuse from artificial increases". *Western Natl. Mut. Ins. Co. v. Commissioner*, 102 T.C. at 350. Respondent contends that this point does not undermine her position, because Congress sometimes finds it expedient to adopt bright-line rules that do not in every case effectuate congressional intent precisely.

Because respondent believes that the statute is ambiguous and the regulations in issue effectively implement the conference committee's definition of "reserve strengthening", she maintains that the regulations reflect a reasonable and permissible construction of the statute.

Respondent argues in the alternative that, if we hold that "reserve strengthening" includes only those increases in reserves attributable to changes in methodology or assumptions, we should determine a lesser deficiency, because all or some of petitioner's additions to its IBNR and LAE reserves resulted from management's discretionary adjustments.

V. *Petitioner's Position*

Consistent with this Court's holding in *Western National*, petitioner maintains that the term "reserve strengthening" is an insurance industry term of art with a clearly understood technical meaning. As used in the insurance industry, petitioner argues, "reserve strengthening" encompasses only those increases in loss reserves that are attributable to nonperiodic, significant changes in the assumptions and/or methodologies used to establish such loss reserves. Because the increase in petitioner's 1986 reserves for pre-1986 accident years occurred without a change in methodology, petitioner contends that the increase does not constitute "reserve strengthening".

Petitioner further argues that there is no need to consider the legislative history to interpret the term "reserve strengthening", because the term is unambiguous. Accordingly, petitioner argues that the regulatory definition of "reserve strengthening" is invalid to the extent that it treats all net additions in 1986, to pre-1986 loss reserves, as "reserve strengthening".

VI. *Analysis and Conclusion*

Despite respondent's cogent arguments to the contrary, we hold that petitioner's reserve increases do not constitute "reserve strengthening". The facts of *Western National* are indistinguishable from the present case. Therefore, the doctrine of stare decisis leads us to the same result. In each case, the taxpayer's reserves, for pre-1986 years, at yearend 1986 exceeded its reserves at yearend 1985, and that excess reflected routine adjustments made consistent with past reserving practices. In each case, the

taxpayer did not change its reserving assumptions or methodology.

Respondent attempts to distinguish the present case from *Western National* based on the submission of expert testimony. In *Western National*, respondent chose not to submit expert testimony and instead contended that congressional intent, as expressed in the conference committee report, was determinative. Having lost on that argument, respondent has submitted expert testimony in the present case in her attempt to establish that the term "reserve strengthening" is subject to more than one interpretation.

The Court's decision in *Western National*, however, was not based solely on expert testimony. In fact, the Court in *Western National* acknowledged that the expert testimony submitted in that case "did not establish a universal and precise definition of reserve strengthening" but concluded that the testimony did provide "sufficient guidance to enable our recognition of the conceptual elements involved in industry jargon." *Western Natl. Mut. Ins. Co. v. Commissioner*, 102 T.C. at 351 n.10. Moreover, several of the factors cited by the Court for its decision in *Western National* did not depend on expert testimony. For example, the Court stated that: (1) Congress previously had used the term "reserve strengthening" in a life insurance industry statute in a manner consistent with the taxpayer's interpretation; (2) respondent's regulation created anomalous results; and (3) the taxpayer's interpretation of the term comported with Congress' objective of preventing willful abuse of the fresh start provision.

Respondent argues in the alternative that we should determine a lesser deficiency, because all or some of

petitioner's additions to its IBNR and LAE reserves resulted from management's discretionary adjustments. We disagree. In both *Western National* and the present case, case reserves formed the majority of petitioner's loss reserves and were not adjusted by management. Moreover, in both cases senior management retained some discretion to adjust the reserve amounts arrived at through formulaic computations, and both taxpayers maintained that the adjustments were made pursuant to actuarial data to ensure the adequacy of reserves. There were no increases to the reserves for the period in question attributable to changes in underlying assumptions or methodology.

To reflect the foregoing,

Decision will be entered for petitioners.

TAX REFORM ACT OF 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2404, 99th Cong., 2d Sess. §1023(e) (1986).

Sec. 1023. DISCOUNTING OF UNPAID LOSSES AND CERTAIN UNPAID EXPENSES.

* * * * *

(e) EFFECTIVE DATE.--

* * * * *

(2) TRANSITIONAL RULE.- For the first taxable year beginning after December 31, 1986-

(A) the unpaid losses and the expenses unpaid (as defined in paragraphs (5)(B) and (6) of section 832 (b) of the Internal Revenue Code of 1986) at the end of the preceding taxable year, and

(B) the unpaid losses as defined in sections 807(c)(2) and 805(a)(l) of such Code at the end of the preceding taxable year,

shall be determined as if the amendments made by this section had applied to such unpaid losses and expenses unpaid in the preceding taxable year and by using the interest rate and loss payment patterns applicable to accident years ending with calendar year 1987. For subsequent taxable years, such amendments shall be applied with respect to such unpaid losses and expenses unpaid by using the interest rate and loss payment patterns applicable to accident years ending with calendar year 1987.

(3) FRESH START.-

(A) IN GENERAL.-Except as otherwise provided in this paragraph, any difference between

(i) the amount determined to be the unpaid losses and expenses unpaid for the year preceding the 1st taxable year of an insurance company beginning after December 31, 1986, determined without regard to paragraph (2), and

(ii) such amount determined with regard to paragraph (2),

shall not be taken into account for purposes of the Internal Revenue Code of 1986.

(B) RESERVE STRENGTHENING IN YEARS AFTER 1985.-Subparagraph (A) shall not apply to any reserve strengthening in a taxable year beginning in 1986, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December 31, 1986.

DEFICIT REDUCTION ACT OF 1984, Pub. L. No. 98-369, 98 Stat. 494, 758, 98th Cong., 2d Sess., § 216.

Sec. 216. RESERVES COMPUTED ON NEW BASIS; FRESH START.

(a) RECOMPUTATION OF RESERVES.-

(1) IN GENERAL.--As of the beginning of the first taxable year beginning after December 31, 1983, for purposes of subchapter L of the Internal Revenue Code of 1954 (other than section 816 thereof), the reserve for any contract shall be recomputed as if the amendments made by this subtitle had applied to such contract when it was issued.

* * * * *

(b) FRESH START.--

(1) IN GENERAL.--Except as provided in paragraph (2), in the case of any insurance company, any change in the method of accounting (and any change in the method of computing reserves) between such company's first taxable year beginning after December 31, 1983, and the preceding taxable year which is required solely by the amendments made by this subtitle shall be treated as not being a change in the method of accounting (or change in the method of computing reserves) for purposes of the Internal Revenue Code of 1954.

* * * * *

(3) REINSURANCE TRANSACTIONS, AND RESERVE STRENGTHENING, AFTER SEPTEMBER 27, 1983.

(A) IN GENERAL.--Paragraph (1) shall not apply (and section 807 (f) of the Internal Revenue Code of 1954 as amended by this subtitle shall apply--)

(i) to any reserve transferred pursuant to--

(I) a reinsurance agreement entered into after September 27, 1983, and before January 1, 1984, or

(II) a modification of a reinsurance agreement made after September 27, 1983, and before January l, 1984, and

(ii) to any reserve strengthening reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984.

Clause (ii) shall not apply to the computation of reserves on any contract issued if such computation employs the reserve practice used for purposes of the most recent annual statement filed before September 27, 1983, for the type of contract with respect to which such reserves are set up.

TREASURY REGULATIONS ON INCOME TAX (26 C.F.R.):

§1.846-3(c) Rules for determining the amount of reserve strengthening (weakening)--(l) In general. The amount of reserve strengthening (weakening) is the amount that is determined under paragraph (c)(2) or (3) to have been added to (subtracted from) an unpaid loss reserve in a taxable year beginning in 1986. For purposes of section 1023(e)(3)(B) of the 1986 Act, the amount of reserve strengthening (weakening) must be determined separately for each unpaid loss reserve by applying the rules of this paragraph (c). This determination is made without regard to the reasonableness of the amount of the unpaid loss reserve and without regard to the taxpayer's discretion, or lack thereof, in establishing the amount of the unpaid loss reserve. The amount of reserve strengthening for an unpaid loss reserve may not exceed the amount of the reserve, including any undiscounted strengthening amount, as of the end of the last taxable year beginning before January 1, 1987. For purposes of this section, an "unpaid loss reserve" is the aggregate of the unpaid loss estimates for losses (whether or not reported) incurred in an accident year or line of business.

(2) Accident years after 1985--(i) In general. The amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year after 1985 is the amount by which that reserve at the end of the last taxable year beginning in 1986 exceeds (is less than) a hypothetical unpaid loss reserve.

(ii) Hypothetical unpaid loss reserve. For purposes of this paragraph (c)(2), the term "hypothetical unpaid loss reserve" means a reserve computed for losses the estimates of which were included, at the end of the last taxable year beginning in 1986, in the unpaid loss reserve for which reserve strengthening (weakening) is being determined. The hypothetical unpaid loss reserve must be computed using the same assumptions, other than the assumed interest rates in the case of reserves determined on a discounted basis for annual statement reporting purposes, that were used to determine the 1985 accident year reserve, if any, for the line of business for which the hypothetical reserve is being computed. If there was no 1985 accident year reserve for that line of business, the hypothetical unpaid loss reserve is the reserve, at the end of the last taxable year beginning in 1986, for which reserve strengthening (weakening) is being determined (and thus there is no reserve strengthening or weakening).

(3) Accident years before 1986--(i) In general. For each taxable year beginning in 1986, the amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 is the amount by which the reserve at the end of the taxable year exceeds (is less than)--

(A) The reserve at the end of the immediately preceding taxable year; reduced by

(B) Claims paid and loss adjustment expenses paid ("loss payments") in the taxable year beginning in 1986 with respect to losses that are attributable to

the reserve. The amount by which a reserve is reduced as a result of reinsurance ceded during a taxable year beginning in 1986 is treated as a loss payment made in the taxable year.

(ii) Exceptions. Notwithstanding paragraph (c) (3) (i) of this section, the amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 does not include--

(A) An amount added to the reserve in a taxable year beginning in 1986 as a result of a loss reported to the taxpayer from a mandatory state or federal assigned risk pool if the amount of the loss reported is not discretionary with the taxpayer; or

(B) Payments made with respect to reinsurance assumed during a taxable year beginning in 1986 or amounts added to the reserve to take into account reinsurance assumed for a line of business during a taxable year beginning in 1986, but only to the extent that the amount does not exceed the amount of a hypothetical reserve for the reinsurance assumed. The amount of the hypothetical reserve is determined using the same assumptions (other than the assumed interest rates) that were used to determine a reserve for reinsurance assumed for the line of business in a taxable year beginning in 1985.